MARCH 29, 1982 TWO DOLLARS AND FIFTY CENTS

Forbes

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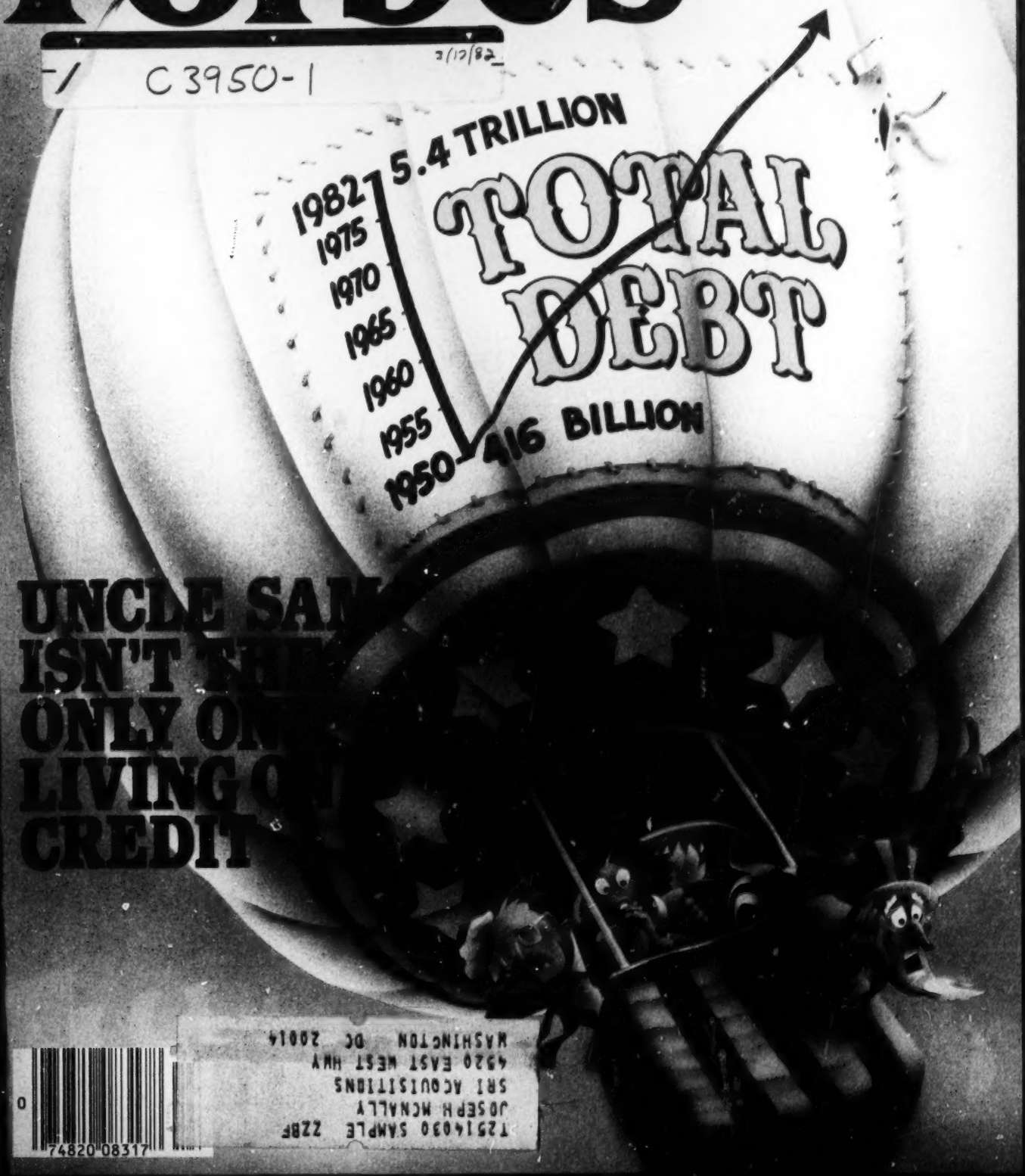

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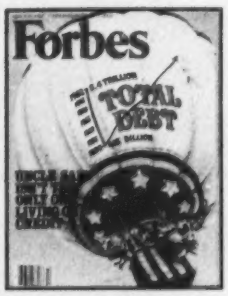
March 29, 1982
Volume 129,
Number 7



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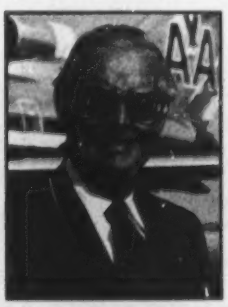

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Photos:
8, Jacob Sutton/Gamma Liaison; 12, John Chang McCurdy; 21, UPI; 33, 66, 70, Shelley Katz; 35, Patrick Pagnano; 37, 58, 60, 88, 134 bottom, Bill Kelly; 38 left, Theo Westenberger/Gamma Liaison; 50, Humphrey Sutton; 51, Gary Bishop/Gamma Liaison; 52, Bruce Heortel; 54, 133 top, Lawrence Barns; 56, 127 bottom, 130 top left, Les Wollam; 64, Thomas Lea; 74, 134 top, 135 top and bottom, Eric Poggenpohl; 77, John McGrail; 85, Robin Laurence; 94, Arnold Zann/Black Star; 110, 149, Richard Faverty; 118, Chuck Fishman; 127 top left, Timothy Eagan; 127 top right, Judith Gefter; 130 top right, John Grossman; 130 bottom, Jim Schugar/Black Star; 133 bottom, Craig Perman; 146, Fred DeVan

Illustrations:
90, 114, 115, 120, 121 Chas. B. Slackman; 99, Gary Hallgren; 132, Steve Hochman

Cover Illustration:
Gary Hallgren

Forbes (ISSN 0015 6914) is published biweekly by Forbes Inc., 60 Fifth Ave., New York, N.Y. 10011. Second-class postage paid at New York, N.Y. and at additional mailing offices. Subscription $33 a year, U.S.A. Postmaster: Send address changes to Forbes, 60 Fifth Ave., New York, N.Y. 10011.

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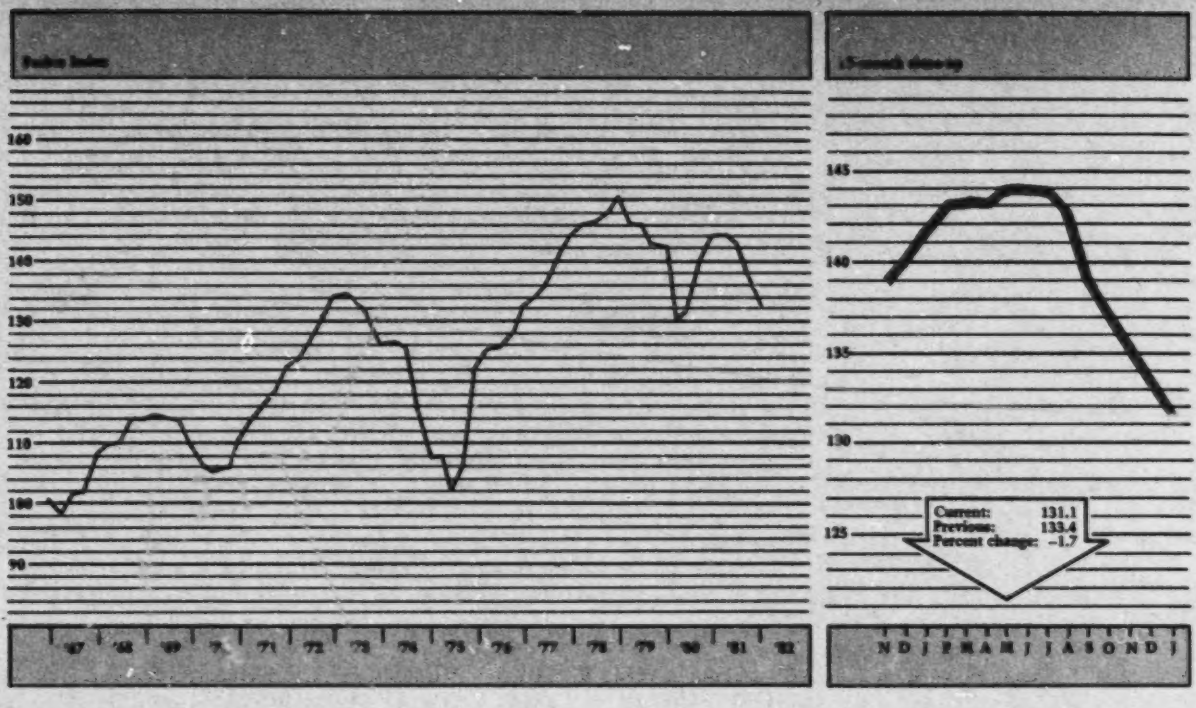
The Forbes Index



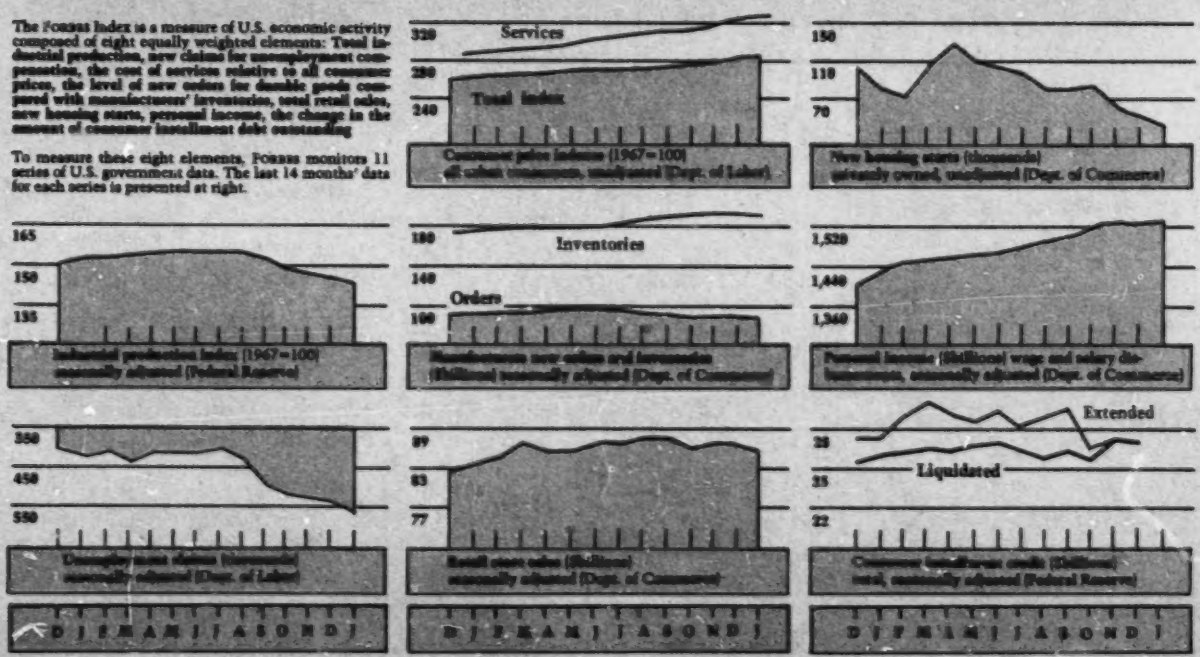
Going down. The Forbes Index is still sinking. And once again, the bad news involves unemployment claims, which increased another 3.1% during the latest reporting period. But high unemployment is only part of the story. Also on the downside were manufacturers' new orders, off by 1.7%.

There are some bright spots, however. One is the Consumer Price Index, which increased by only 0.4% in January. That translates to an annual inflation rate of 4.8%. Another is inventories, which fell by 0.4%. Declining inventories could, of course, indicate that the ongoing recession is nearing its bottom. On the other hand, the bottom may already be past.

The Forbes Index Components

The Forbes Index is a measure of U.S. economic activity composed of eight equally weighted elements: Total industrial production, new claims for unemployment compensation, the cost of services relative to all consumer prices, the level of new orders for durable goods compared with manufacturers' inventories, total retail sales, new housing starts, personal income, the change in the amount of consumer installment debt outstanding.

To measure these eight elements, Forbes monitors 11 series of U.S. government data. The last 14 months' data for each series is presented at right.



Here's the unpalatable truth about high interest rates: Even with no budget deficit we are never going to keep rates down unless Congress does something about the tax deductibility of interest.

Do you sincerely . . .

By William Baldwin

IS IT ANY WONDER that banks are sometimes the only tenants able to afford rents in fashionable commercial neighborhoods? That fad-following businessmen are trampling one another to get into "financial services"? Gross interest payments are flowing through the economy at a rate approaching $900 billion a year—about $4,000 per year for each American man, woman and child. That's interest, mind you, not debt. It's an increase of 200% since 1976. Interest payments, in short, have risen more than twice as fast as the gross national product.

Numbers like these have lost the power to shock in a society that has come to equate indebtedness with shrewdness, thrift and liquidity with senility. It's clear, however, that the tide is turning. The tremendous burden of debt service is taking a growing toll in bankruptcies, savings-and-loan failures, dividend omissions and continued declines in housing prices.

Meanwhile, the financial markets have all but caved in. Equally bad, the sums are so enormous as to obliterate the profit and loss signals on which economic efficiency depends. K mart, for example, is paying out half of its operating income (after depreciation) in interest costs. Its profits are determined as much by the vagaries of the money market as by the quality of its merchandising. A large chunk of the airline industry is in danger of collapsing under the weight of interest costs *(see chart, p. 106)*. Building-supplies companies like Jim Walter and Wickes are paying out almost all their operating profit to bankers and bondholders. Old leaders like International Harvester and AM International survive only by the sufferance of their lenders. In 1950 the average corporation had $43 of operating income after depreciation to meet each dollar of interest payments; today's figure is less than $4. Liquid assets are down to 24% of short-term liabilities, half of what they were in the 1950s. Aggravating the liquidity problem is the faster maturity of debt: The ratio of short-term to long-term debt on corporate balance sheets has climbed from 40% in the 1950s to 70% today.

The debt-service overhang extends well beyond the corporate world. In the early 1950s, 4% of farm operating income after depreciation went to pay interest. By 1980 the figure had shot up to 44%. Interest on the $700 billion of Treasury securities held outside the federal government will cost $68 billion this year, accounting for 9% of the budget and two-thirds of the deficit. Debt service now eats up 21% of consumers' disposable personal income—seemingly a saturation level, since consumers are cutting back on big-ticket items like cars. That's one reason for the recession.

This year, predicts economist and former vice chairman James O'Leary of U.S. Trust Co. of New York, domestic borrowers will come to the credit markets for $536 billion in new money—over and above funds supplied by retirement of old debt. If this huge borrowing were for productive invest-

People are confused. They think that inflation is bad. But as they come to understand that you can't have both cheap credit under present conditions and stable prices, they wonder if the cure isn't worse than the fever.

ment, it might be a sign of health. Alas, most of the money will go either to finance unproductive consumption by individuals and by government or to pay interest on existing debt. Credit market debt now totals $5 trillion.

The big credit hog will continue to be the U.S. Treasury, busy financing a fiscal 1982 deficit the Reagan Administration projects at $118 billion, including off-budget items. Last year it soaked up $16.3 billion of the scarce supply of long-term financing, leaving room for only $12.5 billion in conventional long-term corporate bonds.

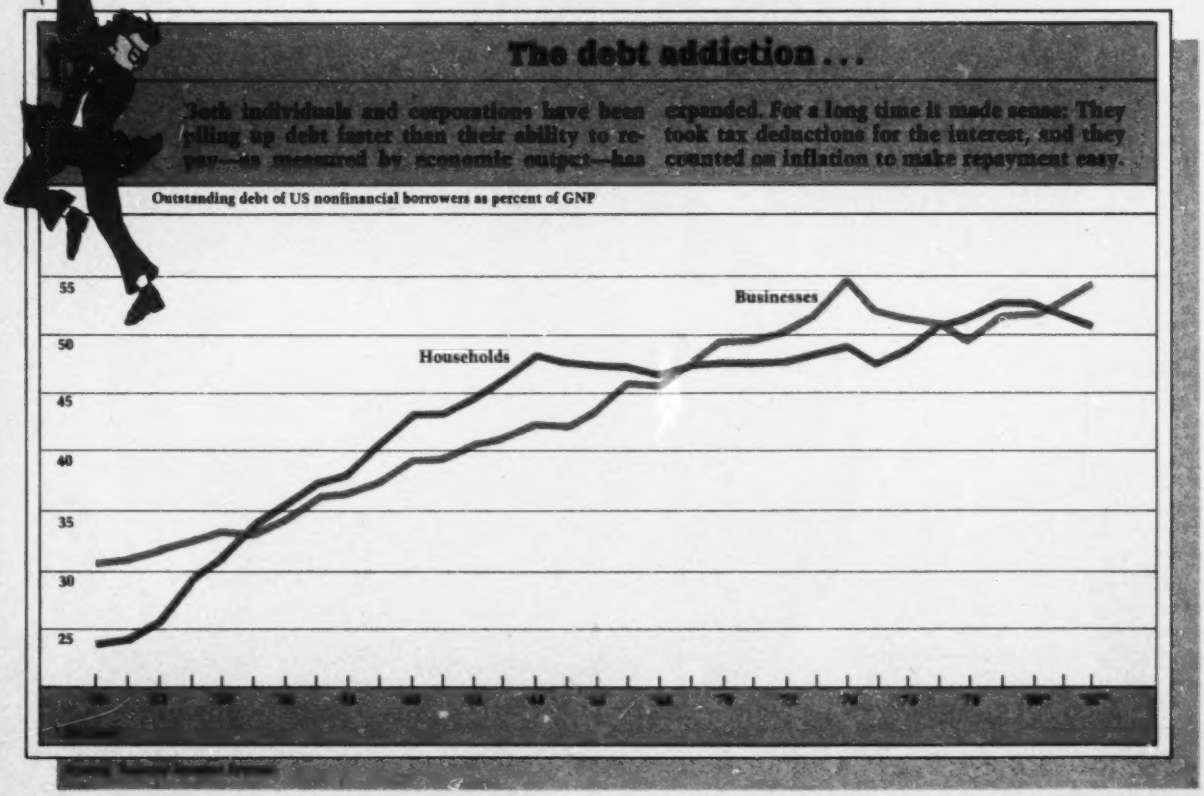
Many a business, meanwhile, suffering from declining sales, is forced to borrow short-term to finance swollen inventories. "With debt at a high percentage of GNP, and tight money, you have to keep borrowing," says economist Raymond Dalio of Bridgewater Associates. "You never get the falloff in interest rates." General Motors was barely in the black last year, so to finance new equipment it had to double long-term debt to $4 billion. That meant $2 billion less that was available for individuals to finance cars.

The economy is now at a perverse turning point. It's in recession—but without the abatement of interest rates that is supposed to come with recession. It's going through disinflation, with all the discomfort that brings to debtors—without enjoying a corresponding drop in the inflation premium built into interest rates. As a result, "real" (inflation-adjusted) interest rates are sky-high, about 10% on a home mortgage or 8% on a long-term corporate bond.

Real rates that high haven't been seen before in this century. How did we get in this fix?

Ill-informed people or politicians with axes to grind can blame the Federal Reserve, "Reaganomics" or "faceless" bankers. In fact, neither governments nor businesses have much freedom of action. The demand for credit exceeds the supply at any reasonable price. It's as simple as that. Printing money would alleviate the credit situation but at the expense of sending inflation soaring. (How does a 25% inflation rate sound? Or 35%?). So, don't blame Paul Volcker. He only inherited the mess.

How did the economy become so debt-happy? The situation is both a product of inflation and a contributing cause. America's debtor mentality said that high interest isn't so bad: Inflation will bail you out, and in the meantime you can write the interest off on your tax return. Farmers who bought land in the 1950s and 1960s enjoyed an untaxed gain that ran well


The debt addiction . . .
Both individuals and corporations have been piling up debt faster than their ability to repay—as measured by economic output—has expanded. For a long time it made sense: They took tax deductions for the interest, and they counted on inflation to make repayment easy.
Outstanding debt of US nonfinancial borrowers as percent of GNP
55
50
45
40
35
30
25
Businesses
Households

ahead of the general inflation rate built into their mortgages. The same asset game is at work in any good real estate tax shelter: High interest, offset by a largely untaxed capital gain in later years, is the magic that makes the shelter so attractive during an inflationary period. Average Americans played the game by bidding up the price of homes.

Corporations did too. Even with the recent runup in real rates, K mart is financing its inventory at negative cost. It pays 14% on its commercial paper, or about 7% after taxes. The goods on the shelf appreciate at the current inflation rate of 8%. K mart isn't taxed on its inventory gains because it's on last-in-first-out accounting. Bottom line: A real aftertax interest rate of minus 1%.

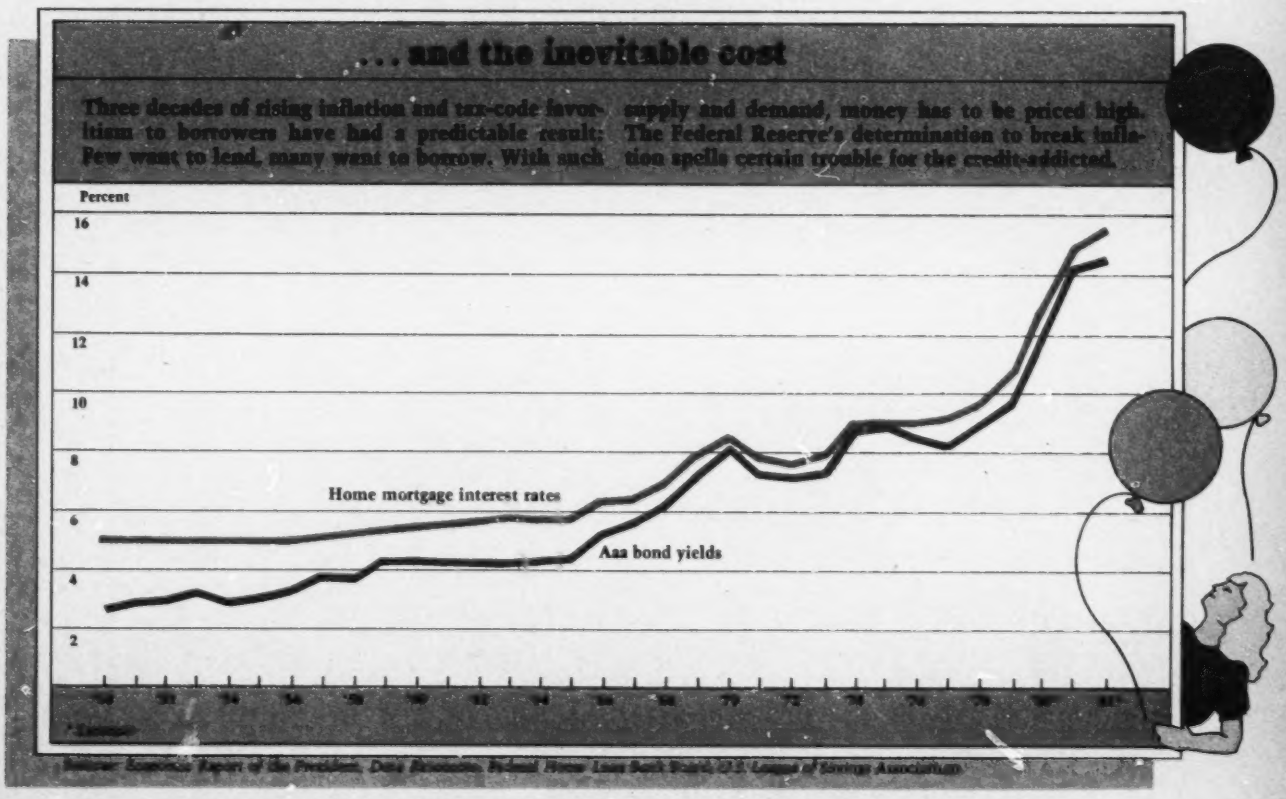
Don't blame corporations for loading up on debt. As Harvard economics Professor Benjamin Friedman says, "There is a bias in the tax code against equity financing." Returns to equity are taxed twice: once at the corporate rate of about 50% (including state taxes) and again as dividends on shareholder returns. Returns to debt are taxed once, since interest is deductible on the corporate return. Teledyne, Metromedia and IC Industries know this well. They have all borrowed money and used the proceeds to retire common stock, thereby boosting earnings per share. Tax deductions on $3 billion in new debt are also helping to pay for U.S. Steel's fling in the oil patch. With speculators like U.S. Steel bidding up the price of existing assets, credit becomes an expensive commodity for the rest of us.

Besides the federal government, two kinds of debtors are at the head of the line today: those who do so to make essentially speculative investments; and those who must borrow—at any cost—to meet payrolls. At the tail end are borrowers for new, productive purposes; they simply can't earn enough to make borrowing worthwhile at these rates.

Arthur Michael Jr., 53, a Pennsylvania entrepreneur, falls into the latter category. Prospective customers of his seven-year-old warehouse construction firm can't afford to finance new buildings. At the same time the few jobs he gets tie up working capital that has to be borrowed at the prime rate. A year ago he and his partner dug their way deeper into the same hole in buying out a John Deere distributor. They speculated on a turnaround in farm profits that didn't come.

Mickey Carawan, 41, a shrimp fisherman in Texas, is caught in the same bind. He lives in Aransas Pass, a tranquil harbor town near Corpus Christi where the parking meters still take pennies but the money rates are tied inexorably to Wall Street. Five years ago he and a partner made a big plunge, buying a $240,000, 80-foot gulf shrimper. In 1980 he was forced to buy the partner out, and refinancing the boat turned a fixed-rate, 10% mortgage into a floating-rate loan that has since soared as high as 18½%. Meanwhile, Mexican fishing fleets, running on cheap diesel oil, have dumped their catch on the American market. Last year Carawan lost $32,000 after making $58,000 in boat payments.

For Carawan, capitalism means 14-hour days with 10- and 20-day stretches at sea. Why did he do it? "It's so peaceful and quiet out there," he says wistfully, standing beside a collection of nets that took in 70,000 pounds of shrimp tails last year. "You're your own boss." His wife, Frances, a bookkeeper, has another explanation: equity. She thought he would sell the boat after a few years and retire to a less demanding business. He doesn't have that option now. "Never in a million years would you buy a boat now," she says, "unless you had the cash, and then you'd be better off putting it in a money market."


. . . and the inevitable cost
Three decades of rising inflation and tax-code favoritism to borrowers have had a predictable result: Few want to lend, many want to borrow. With such supply and demand, money has to be priced high. The Federal Reserve's determination to break inflation spells certain trouble for the credit-addicted.
Percent
16
14
12
10
8
6
4
2
Home mortgage interest rates
Aaa bond yields

Aren't IRAs providing a gush of new savings? Not when taxpayers engage in arbitrage. "Last year I went out and borrowed $1,500 to put in my IRA," says a tax expert. "Not only did I get the exclusion but I could deduct the interest."

For Robert Bush, a 40-year-old former computer engineer who went into the industrial waste disposal business in 1980, the battle is certainly over. Poor marketing and a weak industrial economy around his Grove City, Ohio base hurt the business, he says, but the last straw was a $40,000 annual interest expense. The bank sold off his trucks in November. "Now they're coming to take the house," he says. Entrepreneurs can't expect Paul Volcker to protect them from the construction cycle or cheap imports or poor salesmanship. But these vicissitudes become all the more perilous against a backdrop of high interest costs.

And so the nation's, indeed the world's, 30-year fling with rising inflation is ending in a painful squeeze. People are confused. They think that inflation is bad and should be brought to a halt. But as they gradually come to understand that you can't have both cheap credit under present conditions and stable prices, they wonder if the cure isn't worse than the fever. It's not a new story. A century ago farmers formed the Greenback Party to fight gold-backed currency. They wanted the debtors' relief that comes, for a while at least, with a depreciating currency, *i.e.*, inflation. Today the inflation banner is carried by the housing industry.

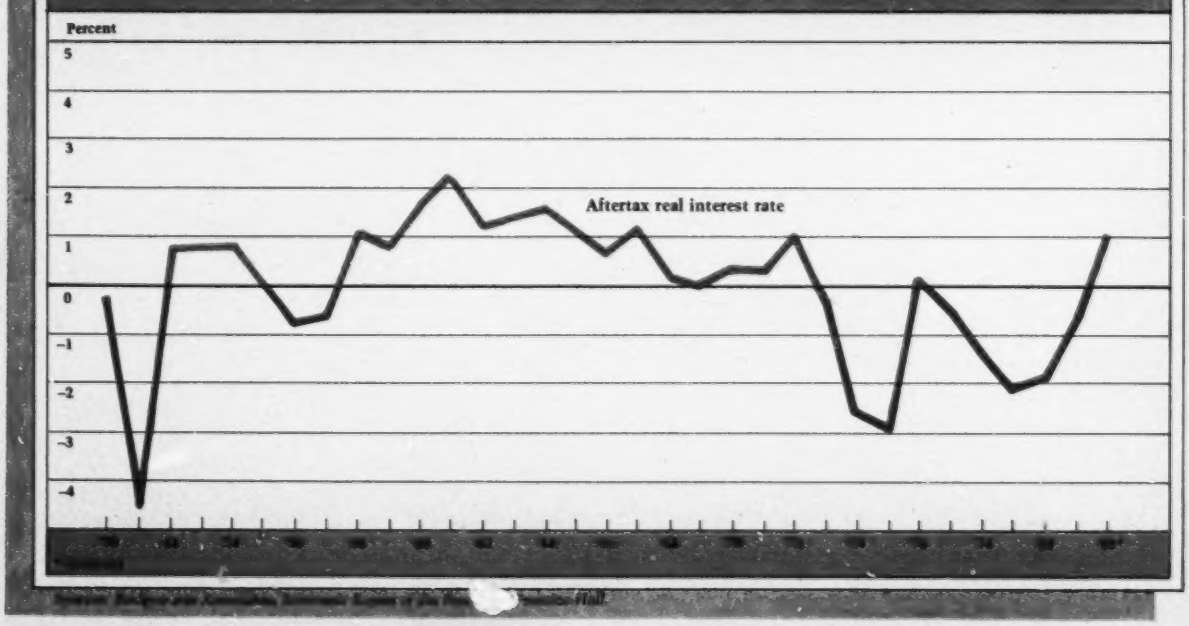
Look, for example, at a recent full-page ad taken out by the National Association of Realtors in the *New York Times*. "Homeowners must act now to make democracy work," it announces. The Realtors want you to write your congressman, asking that the Federal Reserve be urged to speed up the growth of credit. Tight money, they complain, is making it tough for home buyers to get mortgages, and so has sliced $25,000 off the resale value of the average home.

Self-interest wrapped in the flag of democracy. But it wouldn't do for the builders to admit that what they really want is a speedup of inflation to bail them out. Housing is a form of consumption. If it continues to be the favorite at the expense of business capital, productivity will suffer. Do we want to become another economic Argentina, wallowing in populist consumerism while our tools wear out and our technology declines?

This year consumers will save $23 billion by claiming mortgage interest on their tax returns and another $9 billion by running up credit-card and installment bills. Anybody who has forgotten about the deduction need only spend two minutes with a condo or car salesman to be reminded that the tax system will subsidize

Are interest rates too *low*?

These towering rates shown on page 101 take on a new look after inflation and federal income taxes. Here are real aftertax yields on Aaa bonds, for a married taxpayer with a $50,000 salary in constant 1981 dollars and itemized deductions at 20% of income. No wonder people hate to save.



55 of the most heavily burdened

Airlines (see p. 184) aren't the only companies strung out on debt. Each of the companies listed below must pay at least $1 out of every $6 in operating income—most far more than that—merely to meet its interest payments.

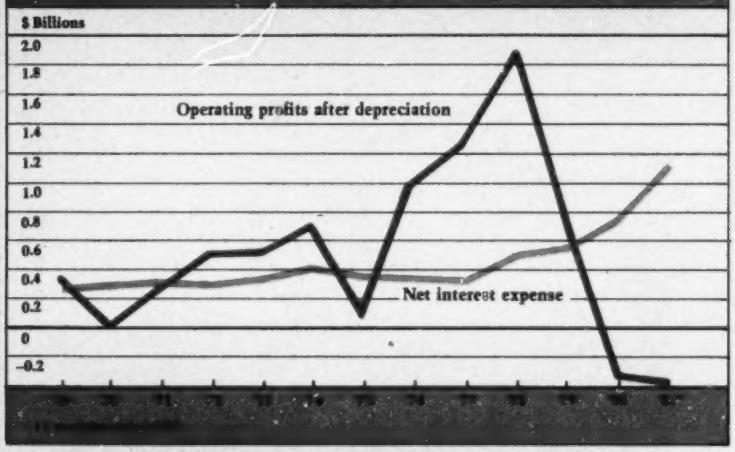
Company	Sales (millions)	Operating income before depreciation (millions)	Interest expense latest 12 months: total (millions)	Interest expense latest 12 months: as % of operating income	Interest expense latest 12 months: as % of common equity	Total debt (millions)	Common equity (millions)
Belco Corp	$ 894.2	$490.6	$261.8	53.4%	117.1%	$1,663.4	$223.6
Kay Corp	697.8	12.5	28.4	226.9	112.0	72.0	25.4
Massey-Ferguson	2,646.3	491.3	324.4	NM	106.4	522.3	304.8
Wickes Cos	4,245.0	237.5	215.6	94.8	76.0	672.0	283.7
NVF Corp	1,045.6	179.3	111.5	140.6	42.4	726.0	262.8
Coastal Corp	5,977.5	292.8	184.4	63.0	38.6	791.9	478.0
Lockheed	5,175.8	201.6	106.1	52.6	34.7	814.7	306.2
Tiger Intl	1,628.4	283.8	153.1	53.9	34.3	1,700.5	446.3
Commonwealth Oil Ref	1,284.4	27.3	44.1	161.3	34.0	190.0	129.8
Total Petroleum	2,379.7	31.1	61.0	196.2	33.5	283.4	182.2
Saxon Industries	754.9	55.8	42.8	76.1	33.3	221.8	127.4
Dome Petroleum	1,514.9	461.0	244.2	53.0	32.9	3,244.6	742.2
Del E Webb	508.7	49.5	42.3	85.5	31.0	212.6	136.7
Humana	1,393.8	319.9	94.5	29.5	31.0	757.1	305.2
Intl Harvester	7,041.0	10.2	896.7	3,870.2	30.9	3,065.5	1,285.0
Kellwood Co	618.1	32.9	25.4	77.1	30.2	66.4	84.0
El Paso Co	3,997.2	524.6	151.9	29.0	30.0	1,308.0	506.4
Chic & N West Trans	1,015.3	103.7	43.1	41.6	27.4	353.8	157.5
Tosco	3,431.5	4.8	59.4	1,236.5	25.9	264.6	229.0
Jim Walter	2,032.8	199.0	178.6	89.7	25.3	692.5	705.0
Mattel	1,029.0	79.3	51.2	64.5	23.3	158.3	219.3
US Home	1,061.4	101.8	60.2	59.1	23.0	213.9	261.9
MCI Communications	413.4	122.3	39.4	32.2	22.6	282.6	174.1
Northeast Utilities	1,655.1	397.1	220.7	55.6	21.8	1,555.8	1,013.2
GATX	992.7	273.5	114.0	41.7	21.7	1,016.8	525.9
Middle South Utilities	2,771.8	544.8	400.1	73.4	21.1	3,513.8	1,898.9
Conagra	1,726.9	69.9	80.5	43.6	20.9	92.4	146.0
Caesars World	608.2	117.3	40.2	34.3	20.5	165.7	196.0
Boston Edison	1,049.6	234.1	92.5	39.5	20.1	623.6	460.2
LTV	7,510.7	343.9	163.5	47.6	20.0	1,510.9	818.0
Transco Cos	3,525.4	689.9	120.2	17.4	19.9	1,251.5	603.8
General Tel & Electric	11,026.3	3,104.2	870.4	28.0	19.4	7,704.0	4,484.4
Eatex	1,081.2	129.7	39.3	30.3	19.4	267.4	202.5
Mitchell Energy & Dev	998.9	247.5	54.1	21.9	18.9	236.9	285.5
Gifford-Hill	575.9	83.0	34.9	42.1	18.9	262.9	184.8
Consumers Power	2,734.0	613.7	308.7	50.3	18.9	2,565.2	1,633.3
Portland General Elec	572.9	271.3	128.8	47.5	18.9	1,054.2	682.1
Pacific Power & Light	1,203.7	471.7	195.9	41.5	18.3	1,708.9	1,070.6
Charter Co	4,982.5	243.2	98.0	40.3	18.2	436.5	537.8
Marriott	2,000.3	239.0	69.8	29.2	18.2	544.2	384.1
Phibro	26,949.3	581.5	259.5	44.6	18.1	441.4	1,431.7
Gulf States Util	1,221.7	335.7	159.4	47.5	17.9	1,332.3	889.2
American Nat Res	2,896.0	534.2	186.7	35.0	17.8	1,408.5	1,051.4
American Elec Power	4,192.9	1,332.1	577.6	43.4	17.5	5,058.8	3,292.3
Detroit Edison	2,054.1	609.6	302.8	49.7	17.5	2,514.7	1,726.8
Fruehauf	2,177.7	133.0	92.6	69.7	17.5	418.9	528.2
Ryder System	1,913.9	381.4	82.2	21.6	17.4	741.4	473.4
Columbia Pictures	734.7	61.5	27.6	44.9	17.3	205.4	159.6
Texneco	15,462.0	2,274.0	815.0	35.8	16.7	4,283.0	4,872.0
Grumman Corp	1,922.4	84.1	46.4	55.1	16.7	240.4	277.4
South Carolina E&G	759.7	217.8	92.0	42.3	16.6	784.9	552.9
Southern Co	4,256.2	1,351.8	515.2	38.1	16.6	5,346.1	3,098.0
American Stores	6,933.7	115.4	42.9	37.2	16.6	224.7	258.3
Southwest Forest Ind	779.5	108.3	40.0	36.9	16.6	328.0	241.4
Zayre	1,759.3	71.6	31.5	44.0	16.5	241.3	190.7

* Deficit. NM: Not meaningful.

Source: Standard & Poor's Compustat, Wilshire Associates, Forbes

Downdrafts

That airline earnings are in a tailspin should be no surprise, in light of what happened in previous recessions. What's frightening is the relentless growth of interest costs in the meantime. The industry can't survive the long haul unless operating profits, after depreciation, run well ahead of interest costs. Interest has quadrupled in a decade. Can the profit line ever catch up?



Instant gratification

Times are tough/Inflation's high
It's hard to buy/Seems you'll never have enough

So goes the jingle in a television ad for Remco, a Houston-based appliance rental chain that caters to that hard core of consumers who don't want to know what the interest rate is, only whether they can meet the monthly payments.

Walk into a plush-carpeted Remco store with good "character" references and the first month's rent and you can walk out with a TV, stereo or other luxury appliance. One popular item: the top-of-the-line General Electric color console with remote control, at $93 a month. You can return the set at any time. Make 18 monthly payments—as 42% of Remco customers do—and the set is yours. Can't meet the payments? At Remco there is no such thing as "repossession," simply cancellation followed by a free pickup.

"Our target is the middle-income consumer, $20,000 to $25,000 family income," says President Charles Sims, who works out of a spanking new headquarters that sports mirror-framed skylights, a racquetball court and a videotaping room. Sims, who founded the business when he was 27 and at 41 still owns 75% of it, made his fortune upscaling what had hitherto been a weekly rental business in low-income neighborhoods.

The chain recorded $38 million in revenues in fiscal 1981 and netted $2 million—a 40% return on equity. Remco's customers pay a tidy price for having eyes bigger than their bank accounts. That GE console comes to $1,674 on the easy-payment plan, *vs.* $985 (including tax) at a local discounter. Add in $99, which Sims says is the value of his service contract, and you're comparing a $1,084 cash transaction with Remco's $1,674. That computes to just under 5.8% a month, or 96% a year after compounding.

Is that interest? Sims maintains it is for the right to cancel freely. Moreover, renters have attractive purchase options in early months. Federal regulators agree, and no interest rate need be disclosed. The customer probably doesn't want to know anyway.—**W.B.**

his purchases on credit—just as it will penalize him heavily if he decides to invest the money instead *(see chart, p. 102)*.

Taxing interest income and allowing interest deductions are an old feature of the tax code. What's troubling now is how these rules create distortions during an inflationary epoch.

"In a world of inflation most of the interest that is paid is really a repayment of principal," says Princeton economist Alan Blinder. If inflation is 8% and the lender wants a real return of 4%, he has to charge a bit more than 12% interest. The extra 8% replaces the erosion in his principal's purchasing power.

Now bring the tax collector into the picture. He will look not at the true interest rate of 4% but at the nominal rate of 12%. If both borrower and lender are in a roughly 50% bracket (corporations or top-bracket individuals, for example), the result will be an aftertax real rate of about minus 2%.

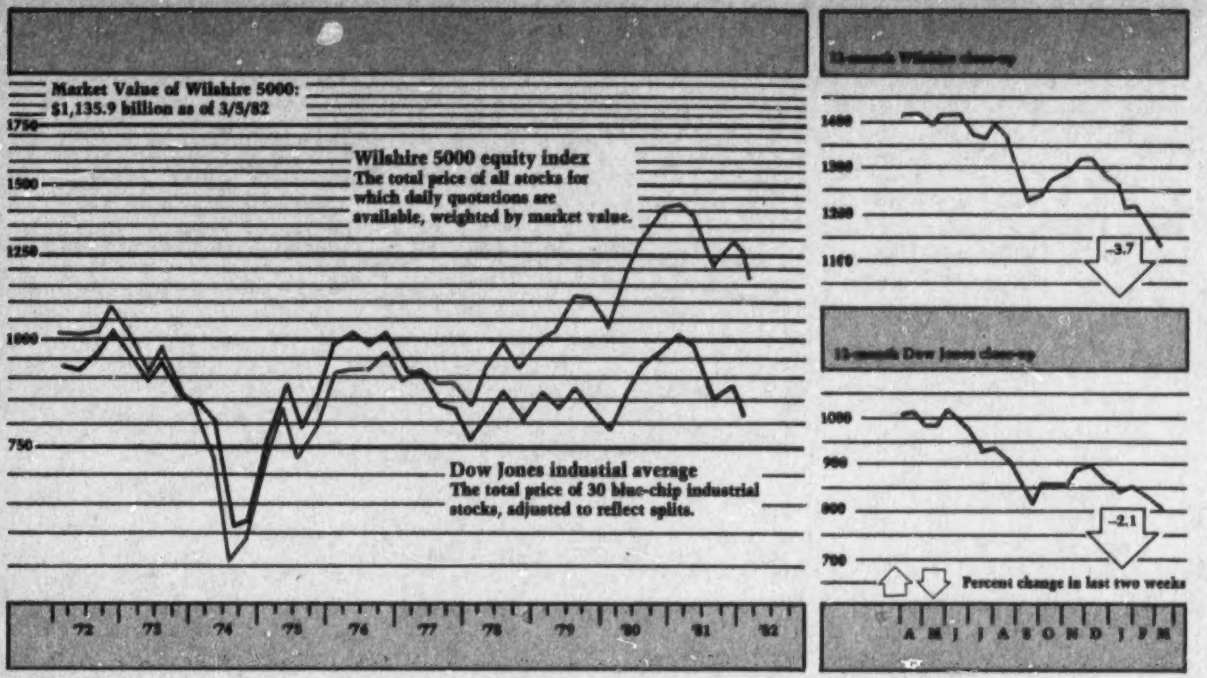
A number of economists, Princeton's Blinder and Stanford's Michael Boskin among them, would like to restrict or abolish both the interest deduction and the taxability of interest income. That would, they argue, increase the supply of credit and diminish the demand, forcing down rates.

What about the IRAs? Aren't they providing a gush of new savings? Not so much as one might think. Here's why: Smart taxpayers are engaging in what *Tax Notes* publisher Thomas Field calls "arbitrage." "Last year I went out and borrowed $1,500 to put in my IRA," he brags. "Not only did I get the exclusion but I could deduct the interest." He wasn't, of course, really saving at all—just playing the tax code. Professor Boskin would like to see the supply of savings swelled by an unlimited IRA deduction. But, he says, "a *quid pro quo* would have to be the elimination—gradually—of the deductibility of interest."

So far Congress has got as far as some very timid talk about a $10,000-a-year cap on mortgage interest deductions. "I've seen it debated on the Hill," says Rudolph Penner, director of tax studies at the American Enterprise Institute and a foe of interest deductions. "But you can see the thought processes going. Everybody is saying to himself, 'How much would it cost me?' Anybody with two houses, a guy with a condominium at the shore, is over $10,000."

So, ask yourself, ask it honestly: "Do I sincerely want inflation to end?" ■

The Forbes Wilshire 5000 Review



Encore for a bad act. Once again, investors had little reason to give the market a standing ovation. This time the show got worse rather than better: Both the Dow and the Wilshire fell to 22-month lows. When the Wilshire—with more than 5,000 securities—joins in chorus with the Dow, the audience knows for sure that the decline in equities is broadly based. The Wilshire indicates that the market lost 3.7% over the last two weeks and 7.1% over the last four. The four-week drop also represents a loss of over $71 billion in capitalization.

Once more the weakest member of the cast of market indicators was the Amex. Motorists may be giving rave reviews to lower prices at the gas pumps, but anything that bears the slightest relation to the energy business has been booed off the stage. The Amex is behind a hefty 25.5% over the last year.

At some point, of course, Wall Street will get its show back on the road. The big question is when. In recent days the Dow has fallen through 800, a mark identified as a resistance level by some experts. With that barrier breached, pessimists are now talking of a bottom at 750 or below. But if the economy doesn't sink much lower, an early spring rally could produce major box office. Already, suave bargain hunters are dancing in the aisles.

Close-up On The Equity Markets

Performance of five leading indexes

Percent change	Wilshire 5000	Dow Jones industrials	NYSE Composite	AMEX Market Value Index	NASDAQ Composite
in last 4 weeks	–7.1	–5.1	–6.9	–12.2	–7.6
in last 52 weeks	–15.8	–16.3	–15.2	–25.5	–13.0

Stock performance based on five key investor yardsticks

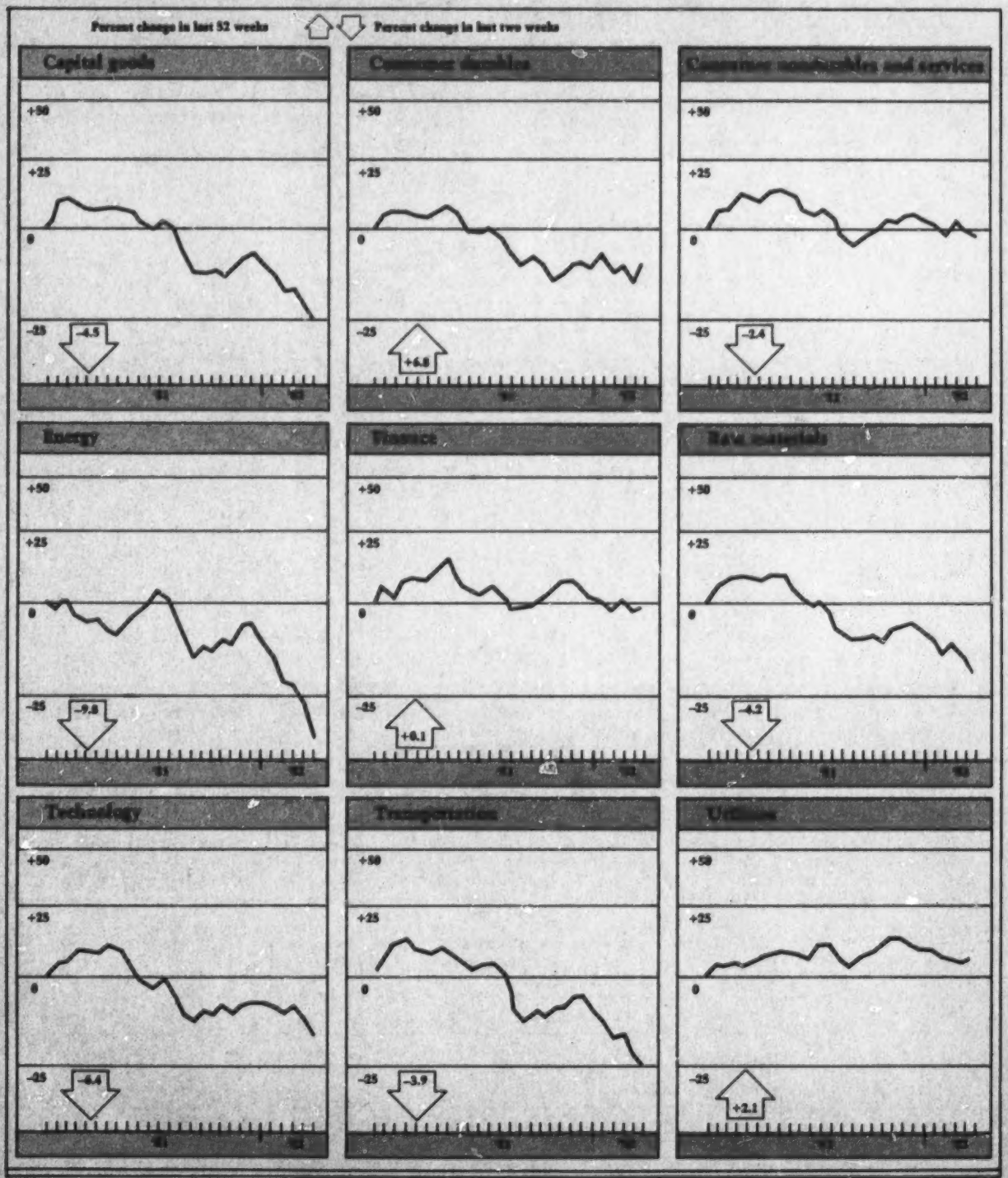
Percent change	Volatility*		P/E multiple		Dividend yield		Growth profile†		Share price	
	high	low	over 25	under 9	over 7.5%	none	high	low	over $40	under $4
in last 4 weeks	–9.9	–0.2	–13.6	–7.1	–0.7	–7.6	–10.3	–2.2	–7.3	–9.6
in last 52 weeks	–13.1	8.5	–26.9	–5.1	5.9	–5.6	–12.5	0.7	–12.5	–2.3

*A stock's sensitivity to overall market movement. High-volatility issues have wide price fluctuations; low-volatility issues are more stable.
†A quantitative evaluation of a stock's growth image, determined by Wilshire Associates.

Note: All data for periods ending 3/5/82. Prepared by Wilshire Associates, Santa Monica, Calif.

Wheels of hope? Six out of nine sectors show two-week declines. The energy stocks in particular were again battered badly, losing almost 10% of their market value. On the other side of the coin, the favorable prospect of lower fuel costs helped utility issues to show a modest 2.1% gain. Consumer durables, however, made the biggest upside move.

A look behind the numbers shows that it was the selective movement of two large capitalization stocks, Ford and General Motors, that got this sector rolling. Ford was up 20% and GM up 16%. It appears that some investors feel that Detroit is about to turn the corner on its protracted slump. Among other big consumer-durable companies, Uniroyal, with a 23% jump, registered the third-largest advance. If the early birds are correct, many auto-related issues could soon be off to the races.



Note: All data for periods ending 3/5/82. Prepared by Wilshire Associates, Santa Monica, Calif.

Do you like stocks that sell under $5 a share? They aren't all traded in Denver. These days there's plenty of budget merchandise on the Big Board.

One kind of cheap

By Steve Kichen

LOTS OF INVESTORS like to buy cheap stocks. Not necessarily cheap in Ben Graham terms—based on low P/E multiples or high book value ratios—but cheap purely and simply in price. How often have you heard someone say, "I'm looking for a good $5 stock"?

This may not be the most logical way to invest, but these days at least it doesn't require loading up on penny-a-share mining outfits. Among the more than 2,200 Big Board securities, there are over 80 common stock issues that sell for $5 or less. Earnings disasters have pushed most of these companies to fire-sale levels—including AM International, Braniff, Chrysler and Pan Am. But there are still almost three dozen profitable NYSE companies currently selling at poor folks' prices.

Of course, some of these stocks are on the discount table because of fundamental financial difficulties, and a few of the companies on our list are only barely profitable. Still, many sectors of American industry are well-represented among our 35 companies.

All of our cheapies may not be the healthiest firms on the block, but some do seem to have traits that will make them survive, perhaps even thrive. A few of the stocks on our list are also cheap based on more conventional criteria. One quarter of the companies sell at an earnings multiple of 6 or less.

Among the more beguiling bargains is Scot Lad Foods. It has a P/E of 4 and also sells at almost half of book value. Saxon Industries, another double-barreled sale item, is available for $4.25 a share and less than 25% of book. A few of the crop even offer relatively safe dividends. Benguet, for example, currently sports a 7.5% yield and IPCO a 4.7% yield.

What's more, within the last 52 weeks most of these stocks sold at considerably higher prices. Christiana Cos. is down 70% from its peak of 15⅜ and Genesco is down 56%. Yes, there's risk—but there's also lots of leverage. Excluding commissions, for example, $1,125 will buy you 1,000 shares of Lehigh Valley Industries. If the stock goes up ⅞ of a point, you earn 78% on your money.

As those numbers sink in, however, remember this: Setting out to find a good $5 stock is like shopping for a red car. There are likely to be both Cadillacs and clunkers on the lot. ■

Is a Cadillac parked with these clunkers?

The 35 Big Board stocks on this list sell for under $5 a share. Each company is profitable, and most are trading near their annual lows.

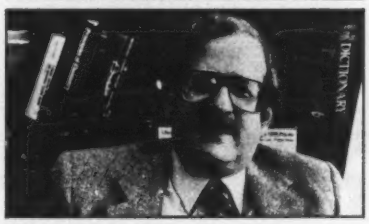
Company/principal business	Recent price	52-week price range	Latest 12-month EPS	P/E	Book value per share
Adams Drug/drugstores	4½	6¾–4	$0.81	6	$7.90
American Agronomics/agriculture	4⅛	8¾–2¾	0.14	29	1.47
Arlen Realty & Dev/real estate	1¼	3 –1⅛	0.49	3	d
Atlantic Metropolitan/real estate	1⅛	3 –1	0.11	10	1.61
Basic Resources NY/energy	4⅜	8 –3⅞	0.48	9	2.14
Benguet Corp/gold	3¾	9 –3⅝	0.78	5	8.04
Christiana Cos/real estate	4⅝	15⅜–4⅜	0.34	14	8.93
Contl Copper & Steel/steel	5	7½–4½	0.20	25	12.39
Cook United/retail	2⅝	10⅜–2⅝	0.11	24	10.35
DMG/real estate	3⅛	6⅜–2⅞	0.11	28	5.39
Elect Mem & Mag/comp equip	3⅛	6⅛–2¾	0.08	39	3.07
First City Properties/real estate	4	5⅞–3¾	0.67	6	7.49
Fotomat/retail	4⅛	9⅜–4⅛	0.21	20	4.95
GF Business Equip/office equip	4¾	7½–3⅜	0.30	16	16.42
Genesco/apparel	4⅞	11⅛–4⅝	0.60	8	0.49
Growth Realty Cos/REIT	2⅜	5½–2⅜	0.08	30	7.49
IPCO Corp/health care prods	4¼	6¾–4	0.47	9	8.07
Jewelcor/jewelry	4	6¾–3⅜	0.92	4	12.73
KDI Corp/recreation	4	5⅜–3¼	0.61	7	2.40
Lehigh Valley Inds/textiles	1⅛	2¼–1	0.22	5	d
Northgate Exploration/metals	3¾	9⅞–3⅝	0.04	NM	7.62
NVF/steel	2⅝	4½–2½	0.33	8	3.16
Pueblo Intl/grocery stores	3½	6⅞–3½	0.64	5	7.56
Puerto Rican Cement/cement	3¼	6½–3	0.35	9	13.65
Pyro Energy/energy	4⅝	7⅞–4½	0.16	29	d
Saxon Inds/office equip	4¼	7½–4	0.42	10	17.68
Scot Lad Foods/groceries	4⅜	7⅜–3⅞	0.99	4	8.41
Steego/auto equipment	3	5⅝–3	0.34	9	5.57
Sunstates/real estate	5	8¼–4¼	0.34	15	9.11
Texfi Inds/apparel	3⅛	5¾–2¾	0.16	20	4.53
Thackery Corp/REIT	2	3½–1¾	0.21	17	5.58
Tri-South Investments/real estate	3½	4¼–2¾	0.86	5	7.48
Union Corp/multicompany	4½	9¼–4⅛	0.48	19	7.39
United Park City Mines/mining	2¼	4¾–2⅛	0.06	NM	3.32
Wean United/machinery	4¾	6⅜–4¼	0.77	9	15.57

d: deficit. NM: Not meaningful. *Source: Wilshire Associates; Standard & Poor's.*

Even Poland had a bumper crop in sugar this year—so you know there must be plenty of it around.

SWEET BUT ASLEEP

By Stanley W. Angrist



The sugar market has been asleep for the last seven months, trading quietly between 12 and 14 cents a pound. The question traders have been asking themselves: Is it going to wake up?

The 1981-82 season looks like a bumper crop for sugar, domestically and worldwide, reversing the previous year's tight supply/demand situation. World production is currently estimated at a record-shattering 95 million metric tons, exceeding the previous high of 92.5 million metric tons produced in the 1977-78 season. Prices have acted just as you would expect in the face of those numbers.

Based on current conditions, sugar production worldwide is estimated to exceed last year's drought-stricken crop by 9%, and is well above the 2.3% trend-line rise of the past decade. It now looks as if the problems that plagued several important sugar-growing regions have been overcome. Eastern Europe has experienced nearly ideal weather conditions, which has led to an excellent crop even in Poland. The only exception is the Soviet Union, which will be forced into the world market again for as much as 2.5 million to 3 million metric tons.

Since the mid-Seventies, world sugar consumption has risen sharply, having increased 18%, to a projected 92 million metric tons. In 1974-75 consumption totaled less than 78 million tons. Most of this increase in demand is attributed to rising population and increasing incomes in developing nations. However, in the last two years consumption growth has slowed or actually declined. Even though consumption is expected to rise 3.5% this crop year, it is well below the 9% growth in production. Whatever growth does occur is expected to occur almost entirely in Asian, African and Latin American nations, while sugar usage in the industrialized nations is expected to decline. Part of this decline is attributed to the increased use of high fructose corn syrup. Examination of the data reveals that, after two years of consumption's exceeding production, the sugar market is going to swing into substantial surplus. On an inflation-adjusted basis, prices this year are expected to be not much higher than they were five years ago. This year's bumper crop will result in a stocks increase, both in absolute terms and as a percent of consumption *(see table above)*.

The Common Market reportedly has decided to stockpile 1 million metric tons of its sugar crop. India is also accumulating domestic reserves of between 500,000 and 1 million metric tons. If the various stockpiling plans are fully or substantially implemented, as now seems likely, they should, in time, remove a substantial portion of the current surplus from the market.

Additional support for prices should come from the planned reductions in sugar-beet production for 1982, with current thinking suggesting a 5% to 10% cutback in spring plantings by major Western European producers.

Given the sugar tonnage that will be taken off the market by the International Sugar Agreement, the high probability that the Russians will be in the market again this year in a substantial way, the cutback in sugar-beet production and the relatively low price, I believe a modest long position in sugar is warranted. I do not expect sugar prices to explode, but they can have a nice bounce from these levels.

Because I believe that this trade will be slow in developing, I suggest taking a long position in the July contract under 13 cents per pound. Look for a 3-cent move, for a $3,360 profit per contract, risking no more than 70 points from the entry position, or $800 per contract. Minimum exchange margins on this position would be $1,500, while the round-turn commission is about $60.

Alternatively, one could try a bull spread of long July/short October, with October at least at a 40-point premium. I would look for July to move to about 60 points over October for a $1,120 profit per spread. I would risk no more than 50 points from my entry point. The margin on this spread is $750; the round-turn commission about $80. ■

Not-so-sweet numbers

Sugar is cheap and getting cheaper as stocks, relative to consumption, continue to grow.

Years	Production	Consumption	Stocks[1]	Surplus (+) or deficit (–)	Stocks as % of consumption	World spot price[2]	Deflated[3] price
	(millions of metric tons, raw value)					(cents per pound)	
1977-78	91.2	85.3	30.7	+5.9	36.0%	7.5	3.7
1978-79	91.0	89.6	31.5	+1.4	35.0	8.2	3.7
1979-80	85.0	89.7	26.3	–4.7	29.0	21.3	8.1
1980-81	87.3	88.7	24.5	–1.4	28.0	24.9	8.7
1981-82	95.0[4]	92.0[4]	29.0	+3.0	32.0	12.1[5]	4.0[5]

[1]On Aug. 31. [2]Season average. [3]Deflated average as adjusted by Producer Price Index. [4]Estimated. [5]Sept. to Dec. 1981 average. *Source: F.O. Licht; Shearson/American Express*

Stanley W. Angrist is a professor at Carnegie-Mellon University and the author of Sensible Speculating in Commodities.